

COMMONWEALTH OF KENTUCKY  
DEPARTMENT OF FINANCIAL INSTITUTIONS

|                           |   |                    |
|---------------------------|---|--------------------|
| IN THE MATTER OF:         | ) |                    |
|                           | ) |                    |
| Morgan Stanley D.W., Inc. | ) | Undertaking        |
| 1585 Broadway             | ) |                    |
| New York, New York 10036  | ) | Case Number V97013 |
| CRD Number 7556           | ) |                    |
|                           | ) |                    |
| Respondent                | ) |                    |
|                           | ) |                    |

I. AUTHORITY AND PARTIES

1. The Commissioner ("Commissioner") of the Kentucky Department of Financial Institutions ("Department") has jurisdiction over this matter pursuant to the Kentucky Revised Statutes §292.310 et seq., as amended ("Act").

2. Recent changes, described as follows, have been made with the election of Governor Ernie Fletcher in late 2003.

3. Pursuant to the authority of Executive Order 2004-031, entered January 6, 2004, by Governor, Ernie Fletcher, the powers and responsibilities of the Department are now vested in the Office of Financial Institutions of the Commonwealth of Kentucky ("Office") and the powers and responsibilities of the Commissioner of the Department are now vested in the Executive Director ("Executive Director") of the Office.

4. During portions of the investigation of this matter, said power and responsibility was or may have been also in the hands of either the Commissioner and/or her Deputy.

5. To the extent such power and responsibility was in the hands of the former Commissioner and/or her Deputy, the Executive Director has affirmed all the acts of the Commissioner and/or her Deputy in this matter as applicable.

6. Consequently, the Executive Director may act in the place of the Commissioner and her Deputy in this matter and this matter is now continued by the Office of Financial Institutions rather than the Department of Financial Institutions.

7. Pursuant to KRS 292.460, the Commissioner and/or her Deputy continuing in her absence, and/or the Executive Director, as applicable, have caused an investigation to be made by the staff of the Department and/or Office to determine whether the Respondent or any one or several of its agents are about to violate or have violated the Act.

8. Respondent, Morgan Stanley Dean Witter ("MSDW") is a corporation that maintains its principal office in New York and is registered pursuant to KRS 292.330 to transact business in Kentucky as a broker-dealer.

## II. EXECUTIVE DIRECTOR'S PRELIMINARY INVESTIGATION

The Office recently conducted an investigation of the securities activities of Steven Condit, a registered representative or agent of the firm, MSDW. As part of this investigation, the Office gathered information concerning MSDW's supervision of Condit and other securities agents employed by MSDW, particularly the actions of Condit in relation to his client, ██████████. The following facts are significant in this matter:

1. The supervisory procedures of MSDW were deficient and the deficiency permitted Condit to mismanage several directed trust accounts. Specifically, the Division found that:

a. The directed trust accounts in question in this matter were for the benefit of ██████████ and her four minor children. ██████████ was a high school graduate who became a widow at the age of 29 when her husband was killed in an

industrial accident. She and her children received a settlement from her husband's employer. The settlement funds were invested in the directed trust accounts. The stated purpose of the trusts is to provide for the long-term support and maintenance of ~~Ms. Stephens~~ and her four minor children.

b. ~~Ms. Stephens~~ was designated as the investment adviser responsible for directing the investments of the trust accounts, even though she had no prior investment experience. Ostensibly, ~~Ms. Stephens~~ as investment adviser for the accounts, would give orders to Condit for execution. However, in fact, it was Condit who determined the investments to be made in the accounts. The term, "investment adviser," has a special meaning in the securities laws, state and federal, and one carrying that label is held out as having a high measure of expertise in investing and investments. ~~Ms. Stephens~~ was not qualified as an investment adviser and should not have ever been designated as such.

c. Condit recommended investments in the trust accounts that were not suitable for the purposes of the trusts and made trades in the accounts for the purpose of generating commissions.

d. Condit's trading activities in the trust accounts were unsupervised by MSDW. Neither Condit's supervisor nor anyone else at MSDW reviewed or approved the trades Condit recommended for the accounts. Further, the trading activity in this account was not included in any reports provided to Condit's supervisor.

### III. INTERVENING EVENTS

Since the Office began its investigation into Mr. Condit and MSDW, some significant events have occurred including the following:

1. Upon notice from the Division of Condit's actions and the deficiencies in its supervisory procedures, MSDW and Morgan Stanley Trust implemented the following new procedures to correct the deficiencies:

a. Trade activity in directed trust accounts shall now be channeled into retail supervisory reports, including trade activity reports which are reviewed daily, and customer activity reports which are reviewed monthly and quarterly.

b. An investment adviser of a directed trust account shall be a registered investment adviser under the Investment Adviser Act of 1940 or an accredited investor as defined by Rule 501 of Regulation D of the Securities Act of 1933. The appointment of an accredited investor who is not a registered investment adviser as an investment adviser for a directed trust account must be in the best interest of the trust.

2. More recently, the Office has communicated with counsel for MSDW. Facts and circumstances have changed since this matter began. Counsel presented the following defense on behalf of MSDW.

a. Changed Circumstances

i. MSDW states that it has upgraded its monitoring systems. According to MSDW, it has always acknowledged its duty reasonably to supervise its agents. Prior to this investigation, MSDW believed that its supervisory procedures addressed all types of accounts. During the course of the investigation, however MSDW discovered a gap in its internal procedures

which affected the level of supervision of trading activity in one type of account: directed trust accounts in which orders are entered by a registered representative at the direction of an individual investment adviser. A directed trust account is one that is directed by a grantor or investment adviser. Directed trust accounts at MSDW may be handled in one of three ways: (a) the investment adviser may direct MSDW to invest the account in mutual funds; (b) the investment adviser may hire a professional money manager to invest the portfolio; or (c) the investment adviser may give orders to a MSDW registered representative for execution, which is how Ms. Stephens accounts were handled.

ii. The last method (above), in which the investment advisor gave instructions directly to the registered representative in the retail system, was employed by only a few directed trust accounts. It is that method in which there was a flaw in the system of supervision. Specifically, because the accounts were assigned a Morgan Stanley Trust identifying number, the branch manager of the Morgan Stanley DW, Inc, branch in which the registered representative was located, did not receive exception reports regarding trading in the account.

iii. Upon discovering this flaw in its system regarding the monitoring of investment activity in directed trust accounts, Morgan Stanley DW Inc., and Morgan Stanley Trust worked to resolve the problem by expanding their supervisory apparatus and procedures to guarantee that trade activity in directed trust accounts is channeled into retail supervisory reports, including

trade activity reports, which are reviewed daily, and customer activity reports, which are reviewed monthly and quarterly. MSDW believes its current supervisory procedures are reasonable and adequate for the supervision of trading in all accounts, including directed trust accounts in which trades are executed by a registered representative at the direction of an investment adviser.

iv. Morgan Stanley Trust states that it is also implemented additional special procedures regarding individuals who may be appointed as investment advisers for directed trusts. Pursuant to a provision in the Stephens trust instruments, at her request, ~~M. Stephens~~ was ultimately designated the investment adviser for her own account and that of her children even though her qualifications for this responsibility are questionable. To avoid this occurrence in the future, Morgan Stanley Trust states that it has revised its policies regarding individuals who may be designated investment advisers of directed trusts. Under the policy change, according to MSDW, any individual who is not a registered investment adviser under the Investment Adviser Act of 1940, will be required, at a minimum, to be an "accredited investor" as that term is defined in Rule 501 in Federal Regulation D of the Securities Act of 1933. In addition, Morgan Stanley Trust states that its policy will require an inquiry beyond the mere fact of "accredited investor" status to help ensure that if the facts and circumstances indicate that appointment of the "accredited investor" would not be in the best interest of the trust, the "accredited investor" will not be so appointed.

v. According to MSDW, subsequent to ~~John Stephens~~ opening her accounts, MSDW implemented a policy requiring the party directing investments in a directed trust account to sign a "directed letter" confirming the procedures for executing trades. The policy states that the account will not be opened until the signed letter is received by Morgan Stanley Trust. According to MSDW, this is an additional mechanism to assure that someone such as ~~John Stephens~~ understands and condones the manner in which execution of trades in a directed trust is to be handled.

b. Mitigating Factors

i. MSDW has entered into settlement agreements with ~~John Stephens~~ and the trusts at issue. As part of the settlement agreement, MSDW is making full restitution based on a "well managed account" theory, i.e., what the value of the accounts would have been had they been invested in certain growth oriented mutual funds rather than in the investments at issue. MSDW is also paying fees and costs, and a premium amount in addition.

ii. MSDW claims that the circumstance which led to ~~John Stephens~~' complaint was an isolated incident caused by an inadvertent gap in supervisory procedures governing cross-over activity occurring between two independent subsidiaries.

iii. MSDW stated that it corrected this error as soon as it was detected.

iv. According to MSDW, ~~John Stephens~~ was the only investor in the State of Kentucky affected by the error; ~~John Stephens~~ was the only Kentucky resident who had the type of accounts at issue (directed trust accounts in

which trades were executed by a registered representative at the direction of an investment adviser) and no other Kentucky residents were potentially at risk due to the supervision gap.

v. MSDW has stated that it has taken action against Mr. Condit by requiring that he obtain additional compliance training at his own expense and that he contribute toward payment of restitution to ██████████

#### IV. ANALYSIS

The Office staff takes the position that the notion of having a customer designated as an investment adviser for the purpose of advising a trust established for her benefit and the benefit of her children, regardless of whether the trust instrument as drafted permits such a designation, to be offensive to the goal of public protection under virtually any circumstances and certainly under these circumstances. However, there is every indication in the record at hand that this was never a regular practice but rather a single event and so the point is moot. Any settlement in this matter is expressly conditioned on that never happening again in the manner it occurred here. With respect to directed trust accounts, MSDW may execute transactions in the account upon the direction of either a trust officer or an investment adviser for the trust but only if the adviser is registered as such with the appropriate state or federal regulator

The Office staff takes the position that the rules of suitability were not adhered to in this matter. Any settlement in this matter is also expressly conditioned on MSDW undertaking to make certain that all its customers are placed in suitable investments and that in the case of trusts, or trust-like instruments, that the purpose of the trust and the beneficiaries are used to determine suitability. Breach of either of the express conditions

stated herein by MSDW are grounds for terminating any settlement reached in this matter.

Notwithstanding the staff's differences in positions, this matter appears to be capable of being settled without resort to stiff penalties for MSDW. The staff is mindful of the steps that MSDW has taken in an effort to correct the problem in this matter and does not lightly dismiss its efforts to remedy the problem. The following points are important.

1. MSDW has entered into settlement agreements with the person reasonably expected to bring a claim against the firm due to its agent's actions.

2. MSDW acknowledges its duty to reasonably supervise its agents. MSDW believes its current supervisory procedures in Kentucky are reasonable and adequate in light of the nature and extent of the business activities of MSDW's agents in Kentucky.

3. MSDW has no reason to believe it now faces supervisory problems with respect to any of its registered representatives in Kentucky. It has every reason to believe that this matter was an unfortunate but isolated incident.

4. MSDW, however, has voluntarily implemented additional special procedures in Kentucky to give itself and the Division further assurances in that regard.

5. MSDW believes that its current supervisory procedures are reasonable in light of the nature and extent of MSDW's business in Kentucky and fully discharge its obligation under Kentucky law to reasonably supervise its agents. MSDW asserts that its failure has been corrected.

6. For those reasons advanced by MSDW, it does not believe any further action by the Division is necessary or appropriate. MSDW asserts that its long history of operations in Kentucky and its willingness to voluntarily upgrade its supervisory apparatus are entitled to favorable consideration by the Division in its disposition of this matter.

The Office states its position as follows.

7. The Office does not necessarily agree with every aspect of all of the assertions and arguments made by MSDW on its behalf but it does not actively dispute them as of the time of entry of this Undertaking.

8. Notwithstanding disagreements that may exist between the Office and MSDW, or may have existed when this matter began, by all appearances circumstances have changed since this matter began and events have occurred which enable the Office and MSDW to resolve this matter without any formal proceedings.

#### V. UNDERTAKING

**WHEREAS**, the staffs of the Securities Division and the Office of General Counsel (now the Office of Legal Services) of the Office, (collectively the "Staff"), in connection with an investigation of this matter believe that reasonable grounds exist to believe that MSDW failed to properly supervise its agents in Kentucky during and/or around the time that Mr. Condit was employed by the firm, but

**WHEREAS**, it appears that circumstances have changed over time, and

**WHEREAS**, MSDW has offered to take certain steps to allay Office concerns and MSDW understands that any failure to comply with this Undertaking shall be the

basis for a recommendation by the Staff to the Executive Director for the issuance of a Notice to begin proceedings for suspension and/or revocation of its registration pursuant to KRS 292.330; and

**WHEREAS**, MSDW desires to resolve the investigation undertaken by the staff with respect to these activities;

**NOW, THEREFORE**, MSDW hereby undertakes and agrees as follows:

1. Morgan Stanley shall take all necessary and appropriate steps to improve its supervisory procedures and practices with respect to each of its registered agents in Kentucky.
2. Morgan Stanley shall institute the changes it mentioned as described herein to prevent the reoccurrence of incidents like the one that caused this matter to accrue.
3. Morgan Stanley shall adhere to the conditions of the staff pertaining to who may act as an investment adviser and adherence to rules of suitability as described above.
4. Morgan Stanley shall make a donation in the amount of *One Hundred Thousand Dollars* (\$100,000.00) to the Investor Protection Trust ("IPT") for the benefit of Kentucky investors.
5. By signing this Undertaking on behalf of Morgan Stanley, the undersigned individual, on behalf of Morgan Stanley, understands and represents that he has read the Undertaking; that he knows and fully understands its contents; and that the entity on whose behalf he signs agrees voluntarily and without threat or coercion of any kind to comply with the terms and conditions of this Undertaking.

IN WITNESS WHEREOF, the undersigned have executed this Undertaking on the dates indicated.

Morgan Stanley D.W., Inc.

By:

*[Handwritten Signature]*

\_\_\_\_\_

*George Sullivan*

Printed Name

**ACKNOWLEDGEMENT**

County of: New York

State of: New York

This Undertaking was acknowledged before me on the 9<sup>th</sup> day of November, 2004, by George Sullivan on behalf of Morgan Stanley D.W., Inc.

*[Handwritten Signature]*  
\_\_\_\_\_  
Notary Public

HOWARD M. SENDROVITZ  
Notary Public, State Of New York  
No. 02SE5068070  
Qualified in New York County  
Commission Expires Oct. 28, 2006

My Commission Expires: \_\_\_\_\_

Executed at Frankfort, Kentucky this 17 day of November, 2004, by:

*Thomas B. Miller*

Thomas B. Miller  
Executive Director  
Office of Financial Institutions  
Commonwealth of Kentucky  
1025 Capital Center Drive, Suite 200  
Frankfort, Kentucky 40601